DOW THEORY LETTERS INC.

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DRAMATIC CHOICES: I have written and rewritten this Letter four times over since first beginning it. Each time I get somewhere, a new and sensational piece of news hits the air, the Letter is scrapped, and I start over again.

Here goes. The weekend of March 29-30 provided one of the biggest news bombshells in recent memory. Foremost, of course was President Johnson's incredibly dramatic announcement that he was not running again for the Presidency. The second dramatic event was agreement by the European Group of Ten regarding Special Drawing Rights (SDR's) to be given its members by the International Monetary Fund.

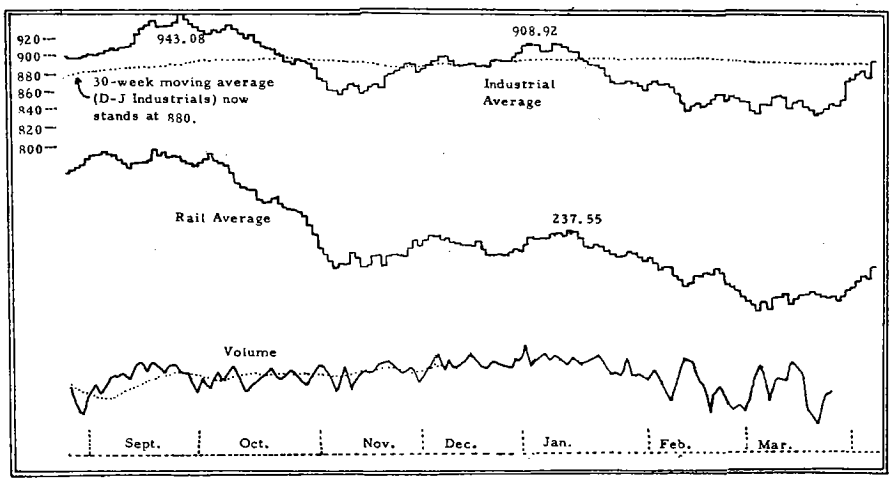
Either announcement alone "appeared" to have been capable of giving the stock market a new lease on life. Together, the two announcements were taken by many to signal the end of the primary bear market which began in February, 1966.

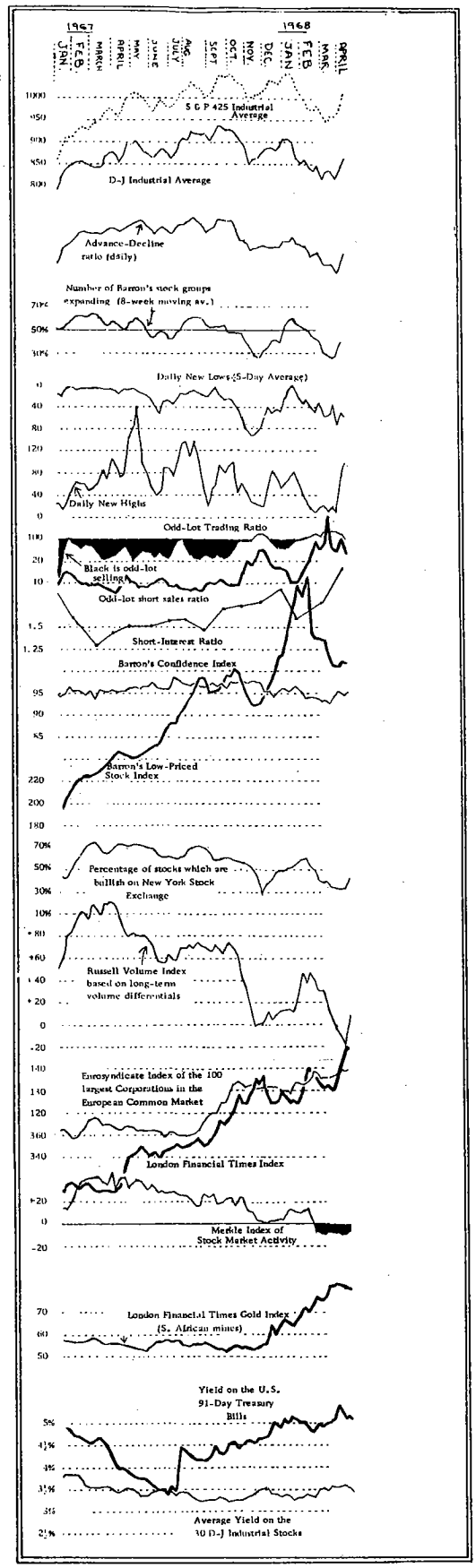
Primary bear markets, however, do not end with dramatic Presidential announcements or international monetary pacts. They do not end with a "blazing news signal" which can be read and appreciated by all. Secondary (and often very important) upward corrections in a primary downtrend often start with such news, but I know of no bear market in history which terminated with glaring newspaper headlines and an implied "everything is going to be all right" from the press and the commentators of the world.

I want to remind newer readers that we are now in the second psychological phase of a primary bear market. This is always the deceptive phase, the phase wherein the market whips back and forth in response first to depressing, bearish news, then to optimistic bullish news. It is normal for people who are heavily invested in the second phase of a bear market to take any bullish developments as signalling "the end of the bear market."

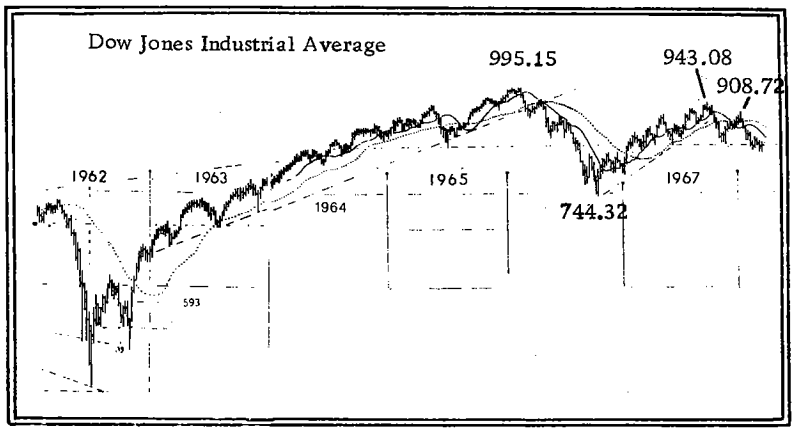
There are two reasons for this "built-in" optimism. First, the wish is father to the thought. People who own a great deal of stock want to believe that a new bull market has started or is just around the corner. Second, the great majority of investors never think in terms of the huge, all-encompassing tide which we call the primary trend.

According to Dow's Theory, a primary bear (or bull) market, once started, will run through all its phases to ultimate conclusion. Yes, there will be foolers, there





will be surprises, there will be optimistic events and hopeful developments. But in the end, Dow's Theory teaches us that the tide of the market and business is like the tide of the ocean. Once high tide is reached, then the water line slowly (often deceptively) recedes and nothing will stop it until the relentless waves of the sea recede to the low water mark. That, stated Charles Dow, is the way the market works. If true, if Dow was right, then the two highs of 995.15 (Industrials) and 271.72 (Rails) will hold inviolate, regardless of upward correction, until the low water mark of the bear market is finally reached.



Referring to the present situation, it is a fact that it has been two years and two months since the Industrials Average recorded its bull market high of 995.15. Both 1967 and 1968 produced important upward corrections, each of which (it was hoped) would carry the Dow above the old high. But the fact (see chart above, courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas) is that each rally fell short of the historic 995.15 peak, the 1967 top fell short by 52 points, the 1968 rally failed by 87 points.

Now a new upward movement is underway, and many investors are hopeful that the Industrials will carry above their 1966 peak of 995.15, the Rails above their corresponding peak of 271.72. The news seems right for a new bull market. The Vietnam war may be liquidated, Special Drawing rights or paper gold may be created, LBJ is leaving the White House.

* * * *

My judgment of President Johnson has been that he was suffering from pride, and the pride would cause him to expand the war into a first rate disaster if not an ultimate World War II. I stated that "pride goeth before a fall." I now feel on the verge of giving the President credit for implicitly admitting the hopelessness of his entire Vietnam stance. In withdrawing from the 1968 Presidential elections, in partially halting the bombing of North Vietnam, the President seems to have swallowed his pride and subtly announced that he was wrong, and that he has identified himself in the eyes of the American people and the world with one of the costliest and most tragic mistakes in American history.

Yet, there are a great many factors which should now be examined. Here are some of them. (1) The partial cessation of the bombing of North Vietnam does not stop the fighting in the South. This is an advantage to Hanoi. In wanting complete cessation of air traffic and bombing over N. Vietnam, Hanoi is also asking for removal of air reconnaissance over the North. Hanoi would then be free to move men and supplies into the South unobserved. This would be a tremendous advantage to them, particularly as negotiations are underway.

(2) We must ask ourselves what Hanoi's goals are. So far, North Vietnam has never admitted that their troops are in the South. Therefore, they will be negotiating only for cessation of war in the North. But Hanoi's real goal is complete control of all of Vietnam. They can only gain this goal via (a) agreement by the U.S. and S. Vietnam, or (b) a military victory via a U.S. military pullout and a S. Vietnam collapse. At the very least, Hanoi wants a coalition government in which it would be very close to power—with the subsequent quick withdrawal of all American troops.

(3) In becoming a lame duck President, LBJ is now morally and politically free to start up the war again—with massive escalation, if the negotiations fail. If it appears that Hanoi is not interested in a negotiated peace with mere concessions, LBJ will have shown the world that he was morally correct, and part of the ground will have been cut out from under Kennedy and McCarthy. LBJ will then push Humphrey for the 1968 Presidential elections.

(4) Hanoi probably knows that it cannot get what it wants from Johnson. What Johnson is willing to give is limited. But Kennedy or McCarthy might be willing to pull all U.S. troops out of Vietnam. For this reason, unless LBJ gives all to Hanoi, it will pay Hanoi to wait for the 1968 election outcome.

(5) It is probable that the U.S.'s European creditors "ordered" an end to the war in Vietnam as the only way to save the dollar. LBJ ordered the peace offensive as a gesture to our creditors that he wanted to give them what they wanted if possible. As one expert was quoted in the April 4 Wall Street Journal, "The European financiers are forcing peace upon us. For the first time in American history, our European creditors have forced the resignation of a President."

(6) On April 4 it was announced in the Journal that "The Administration would select some form of demonetization of gold if another severe international financial crisis arises." The methods would be either "through letting the entire Treasury gold stock be gobbled up by foreign central banks or by halting all sales to them." The other possibility would be outright devaluation or raising the price of gold. Now the following is a cynical statement, but I do not believe our European creditors would want a devaluation until they had called in the remaining $10.5 billion in U.S. gold reserves.

They could ask for it, they could present dollar claims for that gold, even though the U.S. might either hold part for stockpiling purposes or hold all through a gold embargo. But if it appears that the Vietnam war will not be stopped, if it appears that the U.S. is not dead serious about eliminating its balance-of-payments deficit, then the Europeans will take this as a sign that the dollar is finished as a reserve currency.

(7) If the war in Vietnam is not brought to a halt soon, if negotiations break down and perhaps new escalations begin, the U.S. will have its choice of going on a total war economy or writing off the dollar as a reserve currency. If a war economy is instituted together with controls, the stock market will collapse. But even such deflation together with controls might not save the dollar. If it appears that the Vietnam negotiations are fizzling, European central bankers will start calling our gold again. Hanoi knows this and it will act accordingly.

(8) I have heard that our European creditors are giving us approximately 90 days to make the dollar look good. After that, they will start moving to protect themselves, and this would mean asking for our gold, with the probable result being an ending of the dollar as a reserve currency. We are living on borrowed time.

Conclusion: What might have been possible six months or a year ago is not possible now. Time has been working against the U.S. in terms of possible negotiations with Hanoi. With the passage of every day, Hanoi has become more firmly fixed in the driver's seat. Or as Elliot Janeway put it in his latest Service, "The Administration's problem is that it has lost—for how long remains to be seen—the handle it needs to make a genuine cease-fire and negotiations worthwhile to the other side. Contrariwise, the stance of the enemy seems to be to taunt or dare us to continue fighting on, doing more of the same, on the bet that we can afford the test of attrition less than they."

If Hanoi does not get its terms, terms which the U.S. under LBJ cannot give them, they will be in a position to put massive pressure on the dollar by starting up the war again. If the war flares up again, the U.S. will have its choice of writing off the dollar or trying to hold the dollar up with a full war economy and controls.

To understand Hanoi's fierce stance and to understand the pressure which Hanoi has and can bring to bear is to take a dim view of the situation. It seems to me that Hanoi must win or the dollar must go. This is putting it in brutal, cynical terms, but the Communists are brutal and cynical, and they know how to use economics as a major tool in getting what they want.

THE SPECIAL DRAWING RIGHTS: The second phenomenon of the amazing weekend of March 29-30 was the potential creation of SDR's or "paper gold." Here too, I do not believe that all the facts have been faced by the American people. Below are some of the ramifications and problems, as I see them.

(1) The decisions and recommendations of the European Group of Ten must be submitted to the International Monetary Fund this fall. Those recommendations must then be ratified by the U.S. Congress, an event which cannot occur until Congress meets in January, 1969 (ten months from now).

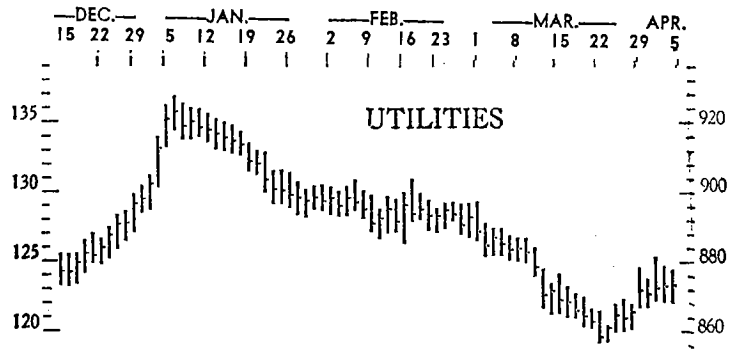
(2) Actual decision regarding the size and timing of the drawings will depend largely on the views of the European members. And most important, the European Economic Community will be handed veto rights over all major decisions. Thus, the U.S.'s creditors will have vital power over U.S. finances. As Barron's put it (April 1), "That concession, incidentally, appears to move the world's financial center from Washington to Brussels (headquarters of the EEC)."

(3) The U.S. has made certain definite commitments to the European central bankers, and as stated in the last Letter those commitments have to do with a surtax, cuts in expenses, higher interest rates, monetary restraints and an elimination of the deficit in the balance of payments. Granting of SDR's will probably depend on the U.S. willingness to adhere to European demands. But, in my opinion, it is highly doubtful whether LBJ or any U.S. President can deliver (via Congress) anything like what the U.S.'s creditors are demanding. From here on, no U.S. juggling, soothing words, ploys, swaps or manipulations are going to work. The U.S. has got to produce for its creditors. One wonders what Robert Kennedy will do in the face of these required stringencies (assuming he is nominated and elected).

THE MARKET: Now we get to the market itself. On April 1 N.Y.S.E. volume was 17.2 million shares, on April 2 volume ran 14.5 million, on April 3 an historic record of 19.2 million shares was seen and on April 4, 14.3 million shares exchanged hands. These four days produced a record 65.2 million shares of volume, which in my mind constitutes the greatest emotional response to a news event ever seen. As my colleague, Joseph Granville, put it, the market literally "crashed" on the upside. James Hughes (co-inventor of the advance-decline ratio) used to term this type of action a "buying-panic."

It is obviously too early to tell whether the 65 million shares which exchanged hands during April 1 to 4 was "smart buying," but one thing is clear. The market compressed almost two weeks of "normal" action into four frenzied days of emotional buying.

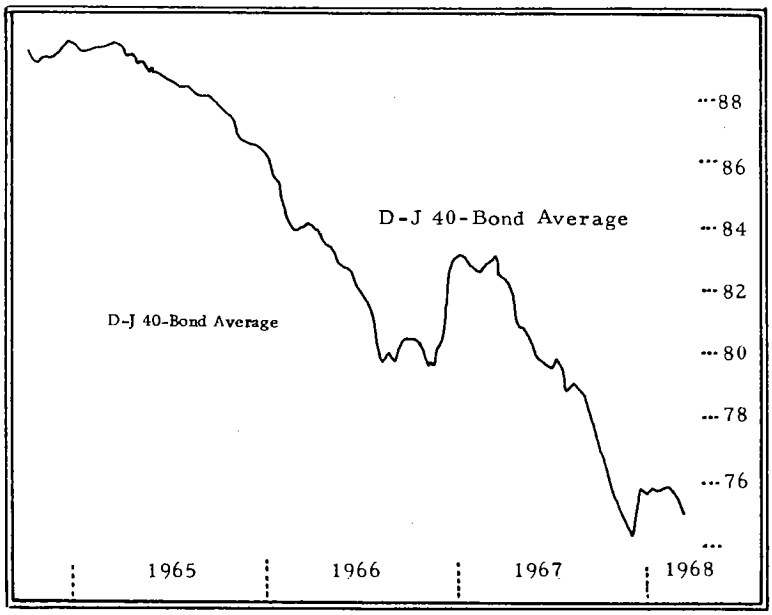
I thought this comment from the April 8 Babson's Report was significant: "It had been a bleak winter for America. Not since Pearl Harbor had the fear of defeat gnawed so ravenously at men's minds. Hence, the degree of relief that swept the nation on the barest hint of peace was so explosive in nature."



Technically, the Dow Industrials dropped from their last peak of 908.92 on January 8 to a low of 827.03 on March 5. This was a decline of 81 points. In the face of the heavily "sold-out" market, in the face of huge short interest and in the face of severe collapse in many stocks. it was not surprising that a new rally was mounted. Considering the importance of the news of the last few weeks, we can appreciate the frenzy and violence of the peace-inspired rally.

The Averages normally correct one-third to two-thirds of any preceding primary movement. Because of the favorable technical condition coupled with the peace news, I would now expect the Dow to move nearer or even above the two-thirds mark on this rally. This could easily bring the Industrials back to the 880 or better level.

On thing we might watch for here is increasing evidence of "churning." This is high volume turnover with little or no price appreciation. Churning is one of the surest telltale signs of distribution in a bear market rally, and I suspect we are going to see signs of churning now and in the near future.



A second area worth watching is the general pattern of the Bond and Utility Averages. If peace is in the offing. there will be a great easing of monetary commitments and a simultaneous easing of interest rates. This should be reflected both in the bond market and in the money-sensitive utility stocks.

I include a four-year chart of the broad D-J 40 Bond Index, showing the steady, often frightening deterioration in this widely followed Average. From the 1964 high above 88, the Average dropped to a 33 year low of 74.62 on December 22, 1967. As of Friday, April 5 the 40-Bonds stood at only 75.28, despite all the bullish (for the money market) implications of a possible peace. One might almost say that the sophisticated bond sector of the markets acted as if they never heard of LBJ's peace move.

The Utility rally too has been rather half-hearted. I have shown the daily chart from the Wall Street Journal with the Utility Average filled in through April 8. So far, judging from the action here, the Utility Average has not really participated in the "peace celebration." It will be interesting to see if, over the near future, the Utilities are able to gain some of the impetus seen in the Industrial and Rail Averages.

* * * *

As this is written the Industrial Average is in the vicinity of its 30-week moving average (which now stands at approximately 878). This moving average is also known as the "investment line" and it represents the average price which investors have been willing to pay for the 30 Dow stocks over the past six months. During last January's rally (see page 1 chart) the Dow moved above its 30-week moving average for a period of about two weeks. Then the rally ran out of steam, and the Dow dropped to new lows during February and March.

So far, the current rally, fed, as it has been, on bullish news and fueled by a huge short position, would appear to have more power than the rally of last January. Therefore, it would not surprise me to see the Dow rise above its moving average this time and stay above it for considerably more time than was the case during January. It may be that the Dow will hold at or above

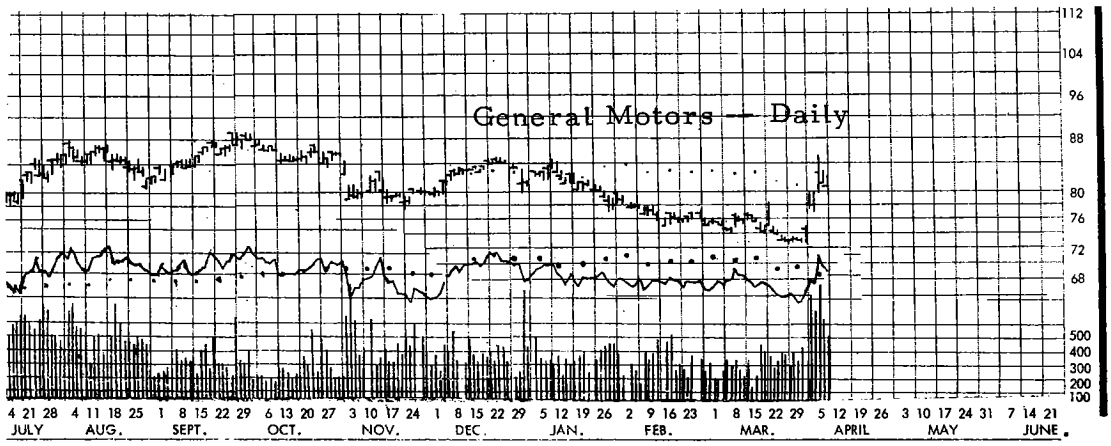
its moving average until the entire Vietnam peace issue is clarified one way or the other. This may take weeks or even months.

In the meantime, I want to warn investors that all of the current action (like the rally action of late 1966 to September, 1967, and like the rally action of November, 1967 to January, 1968) is occurring within the framework of the second phase of a primary bear market. It is occurring within the most deceptive phase of a bear market, and from here on we will again need to exercise patience (as we have all along) as the investor public is swept along, first with optimism, then with pessimism.

In the end, the in-and-out traders in this bear market are going to lose money with their erratic gyrations. But this is something which you can not tell a man. Those who trade in the bear market rallies will have to find this out themselves— the hard way.

DOW THEORY MARKET LABORATORY PAGE

I spent a good deal of time today examining the action of the individual stocks during and after the April 1 period. One surprising phenomenon was that although the D-J Industrial Average "gapped" upward (see chart in the Wall Street Journal), very few Dow stocks actually gapped on the upside. Most of the violent upside (gapping) action occurred in the volative issues such as Control Data and Polaroid.



One of the few Dow exceptions was General Motors. I include a chart of Motors courtesy of Traders Research, 101 Cherry St., Alton, Ill. 62002. Here we see the rare upside gapping action in GM. The gap is caused when the highest intra-day price on one day is not approached by the lowest intra-day price on the following day. This produces the space on the chart, or as it is called in technical language, the gap.

As far as I am concerned, gaps are mainly interesting because they show such force, such breakaway power. Here we see that GM in three days recovered all the ground lost on the entire December to March decline. I do not consider this type of action to be normal reversal action preparatory to a major upward movement. The reversal came with no basing action or period of sideways accumulation. It was as if GM hit a new low one day and the next buyers panicked to purchase it. But the reversal of sentiment which produced the extraordinary gap in GM cannot be expected to dissipate in a day or a week. The action of GM suggests a long period of erratic, emotional gyrations by investors.